

APPENDIX A

Background and Basis for Conclusions

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Introduction

A1. This appendix summarizes considerations that the Public Company Accounting Oversight Board ("PCAOB" or "Board") deemed significant in developing this standard. This appendix includes reasons for accepting certain views and rejecting others.

A2. Section 103(a)(2)(A)(i) of the Sarbanes-Oxley Act of 2002 (the "Act") directs the Board to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report. Accordingly, the Board has made audit documentation a priority.

Background

A3. Auditors support the conclusions in their reports with a work product called *audit documentation*, also referred to as *working papers* or *work papers*. Audit documentation supports the basis for the conclusions in the auditor's report. Audit documentation also facilitates the planning, performance, and supervision of the engagement and provides the basis for the review of the quality of the work by providing the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

A4. The Board's standard on audit documentation is one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The Board believes that the quality and integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work the auditor performed, the conclusions the auditor reached, and the evidence the auditor obtained that supports those conclusions. Meaningful reviews, whether by the Board in the context of its inspections or through other reviews, such as internal quality control reviews, would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential to enhance the quality of the audit and, at the same time, to allow the Board to fulfill its mandate to inspect registered public accounting firms to assess the degree of compliance of those firms with applicable standards and laws.

A5. The Board began a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on the subject. Participants at the roundtable included representatives from public companies, public accounting firms, investor groups, and regulatory organizations.

A6. Prior to this roundtable discussion, the Board prepared and released a briefing paper on audit documentation that posed several questions to help identify the objectives – and the appropriate scope and form – of audit documentation. In addition, the Board asked participants to address specific issues in practice relating to, among other things, changes in audit documentation after release of the audit report, essential elements and the appropriate amount of detail of audit documentation, the effect on audit documentation of a principal auditor's decision to use the work of other auditors, and retention of audit documentation. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard on audit documentation, Statement on Auditing Standards ("SAS") No. 96, *Audit Documentation*, was insufficient for the Board to discharge appropriately its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued for comment, on November 17, 2003, a proposed auditing standard titled, *Audit Documentation*.

A7. The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, government agencies, and others. Those comments led to some changes in the requirements of the standard. Also, other changes made the requirements easier to understand. The following sections summarize significant views expressed in those comment letters and the Board's responses to those comments.

Objective of This Standard

A8. The objective of this standard is to improve audit quality and enhance public confidence in the quality of auditing. Good audit documentation improves the quality of the work performed in many ways, including, for example:

- Providing a record of actual work performed, which provides assurance that the auditor accomplishes the planned objectives.
- Facilitating the reviews performed by supervisors, managers, engagement partners, engagement quality reviewers,^{1/} and PCAOB inspectors.
- Improving effectiveness and efficiency by reducing time-consuming, and sometimes inaccurate, oral explanations of what was done (or not done).

^{1/} The engagement quality reviewer is referred to as the concurring partner reviewer in the membership requirements of the AICPA SEC Practice Section. The Board adopted certain of these membership requirements as they existed on April 16, 2003. Some firms also may refer to this designated reviewer as the second partner reviewer.

A9. The documentation requirements in this standard should result in more effective and efficient oversight of registered public accounting firms and associated persons, thereby improving audit quality and enhancing investor confidence.

A10. Inadequate audit documentation diminishes audit quality on many levels. First, if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done. If the work was not documented, then it becomes difficult for the engagement team, and others, to know what was done, what conclusions were reached, and how those conclusions were reached. In addition, good audit documentation is very important in an environment in which engagement staff changes or rotates. Due to engagement staff turnover, knowledgeable staff on an engagement may not be available for the next engagement.

Audit Programs

A11. Several commenters suggested that audit documentation should include audit programs. Audit programs were specifically mentioned in SAS No. 96 as a form of audit documentation.

A12. The Board accepted this recommendation, and paragraph 4 in the final standard includes audit programs as an example of documentation. Audit programs may provide evidence of audit planning as well as limited evidence of the execution of audit procedures, but the Board believes that signed-off audit programs should generally not be used as the sole documentation that a procedure was performed, evidence was obtained, or a conclusion was reached. An audit program aids in the conduct and supervision of an engagement, but completed and initialed audit program steps should be supported with proper documentation in the working papers.

Reviewability Standard

A13. The proposed standard would have adapted a standard of reviewability from the U.S. General Accounting Office's ("GAO") documentation standard for government and other audits conducted in accordance with generally accepted government auditing standards ("GAGAS"). The GAO standard provides that "Audit documentation related to planning, conducting, and reporting on the audit should contain sufficient information to enable an experienced auditor who has had no previous connection with the audit to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions."^{2/} This requirement has been important in the field of government auditing because government audits have long been reviewed by

^{2/} U.S. General Accounting Office, *Government Auditing Standards*, "Field Work Standards for Financial Audits" (2003 Revision), paragraph 4.22.

GAO auditors who, although experienced in auditing, do not participate in the actual audits. Moreover, the Panel on Audit Effectiveness recommended that sufficient, specific requirements for audit documentation be established to enable public accounting firms' internal inspection teams as well as others, including reviewers outside of the firms, to assess the quality of engagement performance.^{3/} Audits and reviews of issuers' financial statements will now, under the Act, be subject to review by PCAOB inspectors. Therefore, a documentation standard that enables an inspector to understand the work that was performed in an audit or review is appropriate.

A14. Accordingly, the Board's proposed standard would have required that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, the name of the person(s) who performed it, the date it was completed, and the conclusions reached. This experienced auditor also should have been able to determine who reviewed the work and the date of such review.

A15. Some commenters suggested that the final standard more specifically describe the qualifications of an experienced auditor. These commenters took the position that only an engagement partner with significant years of experience would have the experience necessary to be able to understand all the work that was performed and the conclusions that were reached. One commenter suggested that an auditor who is reviewing audit documentation should have experience and knowledge consistent with the experience and knowledge that the auditor performing the audit would be required to possess, including knowledge of the current accounting, auditing, and financial reporting issues of the company's industry. Another said that the characteristics defining an experienced auditor should be consistent with those expected of the auditor with final responsibility for the engagement.

A16. After considering these comments, the Board has provided additional specificity about the meaning of the term, *experienced auditor*. The standard now describes an experienced auditor as one who has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

A17. Some commenters also suggested that the standard, as proposed, did not allow for the use of professional judgment. These commenters pointed to the omission of a statement about professional judgment found in paragraph 4.23 of GAGAS that states, "The quantity, type, and content of audit documentation are a matter of the auditors' professional judgment." A nearly identical statement was found in the interim auditing standard, SAS No. 96, *Audit Documentation*.

^{3/} Panel on Audit Effectiveness, *Report and Recommendations* (Stamford, Ct: Public Oversight Board, August 31, 2000).

A18. Auditors exercise professional judgment in nearly every aspect of planning, performing, and reporting on an audit. Auditors also exercise professional judgment in the documentation of an audit and other engagements. An objective of this standard is to ensure that auditors give proper consideration to the need to document procedures performed, evidence obtained, and conclusions reached in light of time and cost considerations in completing an engagement.

A19. Nothing in the standard precludes auditors from exercising their professional judgment. Moreover, because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate.

Audit Documentation Must Demonstrate That the Work was Done

A20. A guiding principle of the proposed standard was that auditors must document procedures performed, evidence obtained, and conclusions reached. This principle is not new and was found in the interim standard, SAS No. 96, *Audit Documentation*, which this standard supersedes. Audit documentation also should demonstrate compliance with the standards of the PCAOB and include justification for any departures.

A21. The proposed standard would have adapted a provision in the California Business and Professions Code which provides that if documentation does not exist, then there is a rebuttable presumption that the work had not been done.

A22. The objections to this proposal fell into two general categories: the effect of the rebuttable presumption on legal proceedings and the perceived impracticality of documenting every conversation or conclusion that affected the engagement. Discussion of these issues follows.

Rebuttable Presumption

A23. Commenters expressed concern about the effects of the proposed language on regulatory or legal proceedings outside the context of the PCAOB's oversight. They argued that the rebuttable presumption might be understood to establish evidentiary rules for use in judicial and administrative proceedings in other jurisdictions.

A24. Some commenters also had concerns that oral explanation alone would not constitute persuasive other evidence that work was done, absent any documentation. Those commenters argued that not allowing oral explanations when there was no documentation would essentially make the presumption "irrebuttable." Moreover, those commenters argued that it was inappropriate for a professional standard to predetermine for a court the relative value of evidence.

A25. The Board believes that complete audit documentation is necessary for a quality audit or other engagement. The Board intends the standard to require auditors to document procedures performed, evidence obtained, and conclusions reached to improve the quality of audits. The Board also intends that a deficiency in documentation is a departure from the Board's standards. Thus, although the Board removed the phrase *rebuttable presumption*, the Board continues to stress, in paragraph 9 of the standard, that the auditor must have persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached with respect to relevant financial statement assertions.

A26. The term *should* (presumptively mandatory responsibility) was changed to *must* (unconditional responsibility) in paragraph 6 to establish a higher threshold for the auditor. Auditors have an unconditional requirement to document their work. Failure to discharge an unconditional responsibility is a violation of the standard and Rule 3100, which requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with an audit or review of an issuer's financial statements.

A27. The Board also added two new paragraphs to the final standard to explain the importance and associated responsibility of performing the work and adequately documenting all work that was performed. Paragraph 7 provides a list of factors the auditor should consider in determining the nature and extent of documentation. These factors should be considered by both the auditor in preparing the documentation and the reviewer in evaluating the documentation.

A28. In paragraph 9 of this standard, if, after the documentation completion date, as a result of a lack of documentation or otherwise, it appears that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. In those circumstances, for example, during an inspection by the Board or during the firm's internal quality control review, the auditor is required to demonstrate with persuasive other evidence that the procedures were performed, the evidence was obtained, and appropriate conclusions were reached. In this and similar contexts, oral explanation alone does not constitute persuasive other evidence. However, oral evidence may be used to clarify other written evidence.

A29. In addition, more reliable, objective evidence may be required depending on the nature of the test and the objective the auditor is trying to achieve. For example, if there is a high risk of a material misstatement with respect to a particular assertion, then the auditor should obtain and document sufficient procedures for the auditor to conclude on the fairness of the assertion.

Impracticality

A30. Some commenters expressed concern that the proposed standard could be construed or interpreted to require the auditor to document every conversation held with company management or among the engagement team members. Some commenters also argued that they should not be required to document every conclusion, including preliminary conclusions that were part of a thought process that may have led them to a different conclusion, on the ground that this would result in needless and costly work performed by the auditor. Commenters also expressed concern that an unqualified requirement to document procedures performed, evidence obtained, and conclusions reached without allowing the use of auditor judgment would increase the volume of documentation but not the quality. They stated that it would be unnecessary, time-consuming, and potentially counterproductive to require the auditor to make a written record of everything he or she did.

A31. The Board's standard distinguishes between (1) an audit procedure that must be documented and (2) a conversation with company management or among the members of the engagement team. Inquiries with management should be documented when an inquiry is important to a particular procedure. The inquiry could take place during planning, performance, or reporting. The auditor need not document each conversation that occurred.

A32. A final conclusion is an integral part of a working paper, unless the working paper is only for informational purposes, such as documentation of a discussion or a process. This standard does not require that the auditor document each interim conclusion reached in arriving at the risk assessments or final conclusions. Conclusions reached early on during an audit may be based on incomplete information or an incorrect understanding. Nevertheless, auditors should document a final conclusion for every audit procedure performed, if that conclusion is not readily apparent based on documented results of the procedures.

A33. The Board also believes the reference to *specialists* is an important element of paragraph 6. Specialists play a vital role in audit engagements. For example, appraisers, actuaries, and environmental consultants provide valuable data concerning asset values, calculation assumptions, and loss reserves. When using the work of a specialist, the auditor must ensure that the specialist's work, as it relates to the audit objectives, also is adequately documented. For example, if the auditor relies on the work of an appraiser in obtaining the fair value of commercial property available for sale, then the auditor must ensure the appraisal report is adequately documented. Moreover, the term *specialist* in this standard is intended to include any specialist the auditor relies on in conducting the work, including those employed or retained by the auditor or by the company.

Audit Adjustments

A34. Several commenters recommended that the definition of *audit adjustments* in this proposed standard should be consistent with the definition contained in AU sec. 380, *Communication with Audit Committees*.

A35. Although the Board recognizes potential benefits of having a uniform definition of the term *audit adjustments*, the Board does not believe that the definition in AU sec. 380 is appropriate for this documentation standard because that definition was intended for communication with audit committees. The Board believes that the definition should be broader so that the engagement partner, engagement quality reviewer, and others can be aware of all proposed corrections of misstatements, whether or not recorded by the entity, of which the auditor is aware, that were or should have been proposed based on the audit evidence.

A36. Adjustments that should have been proposed based on known audit evidence are material misstatements that the auditor identified but did not propose to management. Examples include situations in which (1) the auditor identifies a material error but does not propose an adjustment and (2) the auditor proposes an adjustment in the working papers, but fails to note the adjustment in the summary or schedule of proposed adjustments.

Information That Is Inconsistent with or Contradicts the Auditor's Final Conclusions

A37. Paragraph .25 of AU sec. 326, *Evidential Matter*, states: "In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." Thus, during the conduct of an audit, the auditor should consider all relevant evidential matter even though it might contradict or be inconsistent with other conclusions. Audit documentation must contain information or data relating to significant findings or issues that are inconsistent with the auditor's final conclusions on the relevant matter.

A38. Also, information that initially appears to be inconsistent or contradictory, but is found to be incorrect or based on incomplete information, need not be included in the final audit documentation, provided that the apparent inconsistencies or contradictions were satisfactorily resolved by obtaining complete and correct information. In addition, with respect to differences in professional judgment, auditors need not include in audit documentation preliminary views based on incomplete information or data.

Retention of Audit Documentation

A39. The proposed standard would have required an auditor to retain audit documentation for seven years after completion of the engagement, which is the

minimum period permitted under Section 103(a)(2)(A)(i) of the Act. In addition, the proposed standard would have added a new requirement that the audit documentation must be assembled for retention within a reasonable period of time after the auditor's report is released. Such reasonable period of time should not exceed 45 days.

A40. In general, those commenting on this documentation retention requirement did not have concerns with the time period of 45 days to assemble the working papers. However, some commenters suggested the Board tie this 45-day requirement to the filing date of the company's financial statements with the SEC. One commenter recommended that the standard refer to the same trigger date for initiating both the time period during which the auditor should complete work paper assembly and the beginning of the seven-year retention period.

A41. For consistency and practical implications, the Board agreed that the standard should have the same date for the auditor to start assembling the audit documentation and initiating the seven-year retention period. The Board decided that the seven-year retention period begins on the *report release date*, which is defined as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. In addition, auditors will have 45 days to assemble the complete and final set of audit documentation, beginning on the report release date. The Board believes that using the report release date is preferable to using the filing date of the company's financial statements, since the auditor has ultimate control over granting permission to use his or her report. If an auditor's report is not issued, then the audit documentation is to be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the seven-year period begins when the work on the engagement ceased.

Section 802 of Sarbanes-Oxley and the SEC's Implementing Rule

A42. Many commenters had concerns about the similarity in language between the proposed standard and the SEC final rule (issued in January 2003) on record retention, *Retention of Records Relevant to Audits and Reviews*.^{4/} Some commenters recommended that the PCAOB undertake a project to identify and resolve all differences between the proposed standard and the SEC's final rule. These commenters also suggested that the Board include similar language from the SEC final rule, Rule 2-06 of Regulation S-X, which limits the requirement to retain some items.

Differences between Section 802 and This Standard

A43. The objective of the Board's standard is different from the objective of the SEC's rule on record retention. The objective of the Board's standard is to require auditors to

^{4/} SEC Regulation S-X, 17 C.F.R. § 210.2-06 (SEC Release No. 33-8180, January 2003). (The final rule was effective in March 2003.)

create certain documentation to enhance the quality of audit documentation, thereby improving the quality of audits and other related engagements. The records retention section of this standard, mandated by Section 103 of the Act, requires registered public accounting firms to "prepare and maintain for a period of not less than 7 years, *audit work papers, and other information related to any audit report*, in sufficient detail to support the conclusions reached in such report." (emphasis added)

A44. In contrast, the focus of the SEC rule is to require auditors to *retain* documents that the auditor does create, in order that those documents will be available in the event of a regulatory investigation or other proceeding. As stated in the release accompanying the SEC's final rule (SEC Release No. 33-8180):

Section 802 of the Sarbanes-Oxley Act is intended to address the destruction or fabrication of evidence and the preservation of "financial and audit records." We are directed under that section to promulgate rules related to the retention of records relevant to the audits and reviews of financial statements that companies file with the Commission.

A45. The SEC release further states, "New rule 2-06 ... addresses the retention of documents relevant to enforcement of the securities laws, Commission rules, and criminal laws."

A46. Despite their different objectives, the proposed standard and SEC Rule 2-06 use similar language in describing documentation generated during an audit or review. Paragraph 4 of the proposed standard stated that, "Audit documentation ordinarily consists of *memoranda, correspondence, schedules, and other documents created or obtained in connection with the engagement* and may be in the form of paper, electronic files, or other media." Paragraph (a) of SEC Rule 2-06 describes "records relevant to the audit or review" that must be retained as, (1) "workpapers and other documents that form the basis of the audit or review and (2) *memoranda, correspondence, communications, other documents, and records (including electronic records), which: [a]re created, sent or received in connection with the audit or review and [c]ontain conclusions, opinions, analyses, or financial data related to the audit or review. ...*" (numbering and emphasis added).

A47. The SEC makes a distinction between the objectives of categories (1) and (2). Category (1) includes audit documentation. Documentation to be retained according to the Board's standard clearly falls within category (1). Items in category (2) include "desk files" which are more than "what traditionally has been thought of as auditor's 'workpapers'." The SEC's rule requiring auditors to retain items in category (2) have the principal purpose of facilitating enforcement of securities laws, SEC rules, and criminal laws. This is not an objective of the Board's standard. According to SEC Rule 2-06, items in category (2) are limited to those which: (a) are created, sent or received in connection with the audit or review, and (b) contain conclusions, opinions, analyses, or

financial data related to the audit or review. The limitations, (a) and (b), do not apply to category (1).

A48. Paragraph 4 of the final standard deletes the reference in the proposed standard to "other documents created or obtained in connection with the engagement." The Board decided to keep "correspondence" in the standard because correspondence can be valid audit evidence. Paragraph 20 of the standard reminds the auditor that he or she may be required to maintain documentation in addition to that required by this standard.

Significant Matters and Significant Findings or Issues

A49. Some commenters asked how the term *significant matters*, in Rule 2-06, relates to the term *significant findings or issues* in the Board's standard. The SEC's release accompanying its final Rule 2-06 states that "... *significant matters* is intended to refer to the documentation of substantive matters that are important to the audit or review process or to the financial statements of the issuer. ..." This is very similar to the term *significant findings or issues* contained in paragraph 12 of the Board's standard which requires auditors to document *significant findings or issues*, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached. Examples of significant findings or issues are provided in the standard.

A50. Based on the explanation in the SEC's final rule and accompanying release, the Board believes that *significant matters* are included in the meaning of *significant findings or issues* in the Board's standard. The Board is of the view that *significant findings or issues* is more comprehensive and provides more clarity than *significant matters* and, therefore, has not changed the wording in the final standard.

Changes to Audit Documentation

A51. The proposed standard would have required that any changes to the working papers after completion of the engagement be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, by whom it was added, and the reason for adding it.

A52. One commenter recommended that the Board provide examples of auditing procedures that should be performed before the report release date and procedures that may be performed after the report release date. Some commenters also requested clarification about the treatment of changes to documentation that occurred after the completion of the engagement but before the report release date. Many commenters recommended that the Board more specifically describe post-issuance procedures. The Board generally agreed with these comments.

A53. The final standard includes two important dates for the preparation of audit documentation: (1) the report release date and (2) the documentation completion date.

- Prior to the report release date, the auditor must have completed all necessary auditing procedures, including clearing review notes and providing support for all final conclusions. In addition, the auditor must have obtained sufficient evidence to support the representations in the auditor's reports before the report release date.
- After the report release date and prior to the documentation completion date, the auditor has 45 calendar days in which to assemble the documentation.

A54. During the audit, audit documentation may be superseded for various reasons. Often, during the review process, reviewers annotate the documentation with clarifications, questions, and edits. The completion process often involves revising the documentation electronically and generating a new copy. The SEC's final rule on record retention, *Retention of Records Relevant to Audits and Reviews*,^{5/} explains that the SEC rule does not require that the following documents generally need to be retained: superseded drafts of memoranda, financial statements or regulatory filings; notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking; previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees; and duplicates of documents. This standard also does not require auditors to retain such documents as a general matter.

A55. Any documents, however, that reflect information that is either inconsistent with or contradictory to the conclusions contained in the final working papers may not be discarded. Any documents added must indicate the date they were added, the name of the person who prepared them, and the reason for adding them.

A56. If the auditor obtains and documents evidence after the report release date, the auditor should refer to the interim auditing standards, AU sec. 390, *Consideration of Omitted Procedures After the Report Date* and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date.

A57. The auditor may perform certain procedures subsequent to the report release date. For example, pursuant to AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement. The auditor should identify and document any additions to audit

^{5/} See footnote 4.

documentation as a result of these procedures. No audit documentation should be discarded after the documentation completion date, even if it is superseded in connection with any procedures performed, including those performed pursuant to AU sec. 711.

A58. Additions to the working papers may take the form of memoranda that explain the work performed, evidence obtained, and conclusions reached. Documentation added to the working papers must indicate the date the information was added, the name of the person adding it, and the reason for adding it. All previous working papers must remain intact and not be discarded.

A59. Documentation added to the working papers well after completion of the audit or other engagement is likely to be of a lesser quality than that produced contemporaneously when the procedures were performed. It is very difficult to reconstruct activities months, and perhaps years, after the work was actually performed. The turnover of both firm and company staff can cause difficulty in reconstructing conversations, meetings, data, or other evidence. Also, with the passage of time memories fade. Oral explanation can help confirm that procedures were performed during an audit, but oral explanation alone does not constitute persuasive other evidence. The primary source of evidence should be documented at the time the procedures are performed, and oral explanation should not be the primary source of evidence. Furthermore, any oral explanation should not contradict the documented evidence, and appropriate consideration should be given to the credibility of the individual providing the oral explanation.

Multi-Location Audits and Using the Work of Other Auditors

A60. The proposed standard would have required the principal auditor to maintain specific audit documentation when he or she decided not to make reference to the work of another auditor.

A61. The Board also proposed an amendment to AU sec. 543 concurrently with the proposed audit documentation standard. The proposed amendment would have required the principal auditor to review the documentation of the other auditor to the same extent and in the same manner that the audit work of all those who participated in the engagement is reviewed.

A62. Commenters expressed concerns that these proposals could present conflicts with certain non-U.S. laws. Those commenters also expressed concern about the costs associated with the requirement for the other auditor to ship their audit documentation to the principal auditor. In addition, the commenters also objected to the requirement that principal auditors review the work of other auditors as if they were the principal auditor's staff.

Audit Documentation, Must be Accessible to the Office Issuing the Auditor's Report

A63. After considering these comments, the Board decided that it could achieve one of the objectives of the proposed standard (that is, to require that the issuing office have access to those working papers on which it placed reliance) without requiring that the working papers be shipped to the issuing office. Further, given the potential difficulties of shipping audit documentation from various non-U.S. locations, the Board decided to modify the proposed standard to require that audit documentation either be retained by or be accessible to the issuing office.

A64. In addition, instead of requiring that all of the working papers be shipped to the issuing office, the Board decided to require that the issuing office obtain, review, and retain certain summary documentation. Thus, the public accounting firm issuing an audit report on consolidated financial statements of a multinational company may not release that report without the documentation described in paragraph 19 of the standard.

A65. The auditor must obtain and review and retain, prior to the report release date, documentation described in paragraph 19 of the standard, in connection with work performed by other offices of the public accounting firm or other auditors, including affiliated or non-affiliated firms, that participated in the audit. For example, an auditor that uses the work of another of its offices or other affiliated or non-affiliated public accounting firms to audit a subsidiary that is material to a company's consolidated financial statements must obtain the documentation described in paragraph 19 of the standard, prior to the report release date. On the other hand, an auditor that uses the work of another of its offices or other affiliated or non-affiliated firms, to perform selected procedures, such as observing the physical inventories of a company, may not be required to obtain the documentation specified in paragraph 19 of the standard. However, this does not reduce the need for the auditor to obtain equivalent documentation prepared by the other auditor when those instances described in paragraph 19 of the standard are applicable.

Amendment to AU Sec. 543, *Part of Audit Performed by Other Independent Auditors*

A66. Some commenters also objected to the proposed requirement in the amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, that the principal auditor review another auditor's audit documentation. They objected because they were of the opinion such a review would impose an unnecessary cost and burden given that the other auditor will have already reviewed the documentation in accordance with the standards established by the principal auditor. The commenters also indicated that any review by the principal auditor would add excessive time to the SEC reporting



University of San Diego

Center for Public Interest Law

Children's Advocacy Institute

Energy Policy Initiatives Center

November 15, 2005

Renata M. Sos, President, and Members
 California Board of Accountancy
 2000 Evergreen Street, Suite 250
 Sacramento, CA 95815-3832

re: CalCPA's Request to Amend Sections 68.3 and 68.4,
 Title 16 of the California Code of Regulations

Dear Ms. Sos and Board Members:

I write to express the concerns of the Center for Public Interest Law (CPIL) about the request by the California Society of Certified Public Accountants (CalCPA), in its letter dated August 17, 2005, for amendments to sections 68.3 and 68.4, Title 16 of the California Code of Regulations.

As many Board members know, these regulations were adopted to implement Business and Professions Code sections 5097 and 5098, which were enacted by the California Legislature in 2002 as part of a multi-bill response to the unprecedented accounting scandals at Enron, WorldCom, and other publicly-traded companies.¹ Effective January 1, 2003, section 5097 enacts strong standards to encourage the creation of adequate audit documentation and the retention of that audit documentation for seven years. Sections 68.3 and 68.4, which implement these audit documentation standards, were adopted by this Board effective January 23, 2004 — these regulations were the product of many months of work by the Board's Reform Statutes Implementation Task Force and its Committee on Professional Conduct, and three lengthy public hearings at which many stakeholders actively participated by submitting both written and oral testimony (October 31, 2002; April 30, 2003; May 16, 2003). In the end, when the Board finally adopted these (and other) regulations on May 16, 2003, its vote was unanimous and reflected a consensus among all the stakeholders.

In the meantime, the Public Company Accounting Oversight Board (PCAOB), which was created in the federal Sarbanes-Oxley Act of 2002, became operational. In September 2003 — after CBA had already adopted its audit documentation regulations — the PCAOB commenced a federal rulemaking proceeding which culminated in its adoption of *Auditing Standard No. 3: Audit Documentation*. That standard did not become effective until November 15, 2004.

¹ During 2002, the California Legislature enacted AB 270 (Correa and Figueroa) (Chapter 231, Statutes of 2002), AB 2873 (Frommer) (Chapter 230, Statutes of 2002), and AB 2970 (Wayne) (Chapter 232, Statutes of 2002) in reaction to the 2001–02 crisis in the accounting profession. Business and Professions Code sections 5097 and 5098 were part of AB 2873 (Frommer).

In its August 17, 2005 letter, CalCPA seeks amendments to sections 68.3 (which addresses the retention period for audit documentation) and 68.4 (which governs changes in audit documentation). CPIL has the following concerns about this request.

1. These regulations are simply too new to change.

CBA's regulations, which became effective on January 23, 2004, are not even two years old. PCAOB's regulation became effective on November 15, 2004 — so it is barely one year old. Neither CBA nor PCAOB have sufficient experience with them to warrant change at this time. CalCPA has neither articulated nor demonstrated any harm, inconvenience, or problem due to the fact that CBA's regulations differ slightly from PCAOB's regulations. This Board expended considerable time and effort crafting its regulations through three public hearings and multiple substantial changes. It is too soon to begin tinkering with them now.

2. PCAOB's regulations are not intended to "occupy the field" or preempt California laws or regulations.

This argument will sound familiar to veteran Board members. Although CalCPA seeks "conformity" with federal regulations, such conformity is not required. Nothing prevents the California Board from adopting regulations that vary from PCAOB's regulations. As stated in the Assembly Floor analysis of AB 2873 in response to the "conformity" argument raised by the large accounting firms in opposition to that bill during 2002: "The federal government does not 'occupy the field' of licensure or regulation of accountants. . . . Each state has the right to craft legislation to meet consumer and investor protections as they arise. According to the Legislative Counsel there is no federal preemption in this area."² Thus, it is perfectly permissible for CBA to have regulations that slightly differ from those of PCAOB.

3. CalCPA's proposed regulations do not conform to PCAOB's regulations.

Although CalCPA says it wants to conform California's regulations to the PCAOB's *Auditing Standard No. 3*, CalCPA's proposal varies from the PCAOB standard. For example, CalCPA would amend section 68.3(a) to trigger the audit documentation retention period on the "date of issuance of the report." However, the PCAOB standard triggers the retention period on the "report release date," defined as "the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements."³

In its June 9, 2004 Release (part of which is quoted by CalCPA in Attachment 3 to its August 17, 2005 letter), the PCAOB was very precise in defining and utilizing "two significant dates" in its audit documentation standard. According to the PCAOB, "[t]o ensure quality and consistency in the preparation and retention of audit documentation, the standard defines two important dates: (1) the report release date and (2) the documentation completion date. The *report release date* is the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. After the report release date, auditors will have 45 days to assemble a complete and final set of audit documentation. The end of this 45-day period is the *documentation completion date*" (*italics original*).

² Assembly Floor Analysis of AB 2873 (Frommer) (August 19, 2002).

³ Public Company Accounting Oversight Board, *Auditing Standard No. 3: Audit Documentation*, ¶ 14.

Although Attachment 2 to CalCPA's letter asserts that the terms "report release date" and "date of issuance of the report" are equivalent, it would appear more prudent to use the PCAOB's term and definition. CPIL would not object to an amendment to section 68.3(a) as follows:

68.3(a). The retention period mandated by Business and Professions Code Section 5097 shall be measured from the report release date, as defined by the Public Company Accounting Oversight Board.

4. CalCPA's version deletes the definition of the term "changes in audit documentation."

CalCPA proposes to completely rewrite section 68.4, which is currently entitled "Changes in Audit Documentation After Issuance of the Report." Of significance and of greatest concern to CPIL, CalCPA proposes deletion of section 68.4(a), which defines the term "changes in audit documentation" to include "any addition, removal, deletion, substitution, or editing of audit documentation, including, but not limited to, physical or electronic additions to any audit documentation file or preexisting audit documentation." This definition in section 68.4(a) is absolutely necessary to carry out the intent of existing section 68.4(b).

CPIL opposes the deletion of this definition (and notes that CalCPA did not oppose it when it was adopted by this Board on May 16, 2003). This definition was extremely important to this Board when adopting its original regulations. This Board's Initial Statement of Reasons (issued January 31, 2003) found that "adoption of section 68.4 is necessary to specify in regulation the procedures for identifying and dating changes in audit documentation. This matter was considered in meetings of the Board's Reform Statutes Implementation Task Force and the full Board. Proposed section 68.4(a) is a result of those discussions. After discussion, *the Board concluded that it is necessary to specify requirements for changes in audit documentation as such changes are sometimes an issue in disciplinary matters*" (emphasis added). Deletion of this comprehensive definition will only lead to litigation of the meaning of the word "change" — which should clearly include not just "addition" but also "removal, deletion, substitution, or editing" of either "any audit documentation file or preexisting audit documentation," as defined by the current regulation.

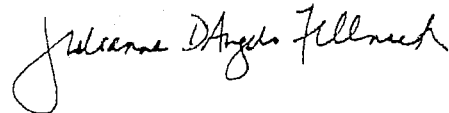
CPIL invites Board members to compare the existing sections 68.4(a) and (b) with those sections as CalCPA proposes to amend them. The amended versions do not accomplish the objectives of the existing sections, as follows:

- (1) As noted above, CalCPA would delete the definition of "changes in audit documentation" in 68.4(a) — which CPIL opposes.
- (2) CalCPA would substitute new language in section 68.4(a) — all of which comes verbatim from the PCAOB's regulation. However, that language does not define the term "changes in audit documentation."
- (3) Existing section 68.4(b) applies documentation requirements to all "changes in audit documentation" as defined in section 68.4(a). However, CalCPA would amend section 68.4(b) to limit its documentation requirements solely to "additions" made after the report release date. Although section 68.4(b) includes detailed procedural requirements regarding "additions" to audit documentation, it does not deal with

"removal, deletion, substitution, or editing" of audit documentation between the report release date and the documentation completion date. In other words, the following sentence of section 68.4(b) — "Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added" — appears to permit the "removal, deletion, substitution, or editing" of audit documentation *between* the report release date and the documentation completion date. This is contrary to the PCAOB's June 9, 2004 Release ("auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date") and with the intent of this Board just two years ago when it adopted section 68.4.

In sum, CPIL would agree to amend section 68.3 (and perhaps other sections) to change the term "report date" to "report release date" as defined and utilized by the PCAOB. However, it opposes the significant and unwarranted changes to section 68.4 that have been proposed by CalCPA. Thank you for your consideration of these comments.

Sincerely,

A handwritten signature in cursive script, reading "Julianne D'Angelo Fellmeth".

Julianne D'Angelo Fellmeth
Administrative Director
Center for Public Interest Law